United States Court of Appeals

for the Second Circuit

REPLY BRIEF

74-2582

United States Court of Appeals

FOR THE SECOND CIRCUIT

ROSALIND FOGEL, *et ano.*,
Plaintiffs-Appellants,

—against—

GEORGE A. CHESTNUTT, JR., *et al.*,
Defendants-Appellees.

REPLY BRIEF ON BEHALF OF LORD, ABBETT & CO. AS AMICUS CURIAE

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I.

Plaintiffs' Proposed Methods of Recapture Were All Unlawful or of Doubtful Legal Validity

Plaintiffs' principal effort to establish the legality of their recapture schemes is to refer to the practice whereby bona fide brokers who were members of stock exchanges and who also happened to advise and manage mutual funds could supply the advice for nothing (or reduce their advisory fees) in exchange for brokerage business for which they charged the full minimum commissions. This practice does not establish the legality of plaintiffs' recapture schemes. It merely shows that the stock exchanges allowed brokers to use their advice as a means of competing for commission business at the full commission rates. As stated in the Special Study relied upon by plaintiffs, "these ancillary services constitute the most significant area of competition among members of the Exchange."* If non-

*Report of Special Study of Securities Markets, 88th Cong., 1st Sess., H. Doc. No. 95, Part 2, p. 321 (1963).

broker investment managers of mutual funds or other funds had generally sought to engage in plaintiffs' recapture schemes without being bona fide brokers, such practices would have seriously subverted the fixed stock exchange commission structure by eliminating it for a favored special class of customers and would have courted legal attack on behalf of the class of customers not so favored.*

Broker affiliations with mutual funds were questioned in the PPI Report which noted that advice received from a broker whose livelihood depends upon his customers' commission business may be tainted with self interest:

> "... such affiliations could possibly lead investment company managers to adopt investment policies that call for high portfolio turnover rates for the purpose of increasing the amount of brokerage commissions obtainable through their relationship with the companies....
>
> * * * * *
>
> "Close affiliations between broker-dealers and investment companies also raise questions relating to the fulfillment of the investment company managers' duty to seek the best execution of portfolio transactions. If its affiliated broker-dealer is an exchange member, the manager of an investment company may be less inclined to consider opportunities for best execution in the third market where the affiliated broker could not earn an exchange commission." (PPI Report, Ex. 4, p. 189)

At p. 190 the Report referred to the "ever-present potential for abuse inherent in investment company-broker relationships."

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* It should be noted that the remedy proposed in the PPI Report for the criticisms directed at brokerage and give-up practices was not the recapture schemes now urged by plaintiffs, but rather the abolition of customer-directed give-ups and the institution of quantity discounts (pp. 17-18, 185-87), but without disturbing the practice of a broker dividing a commission with another broker who performed a "bona fide brokerage" function (p. 186).

In the present case, the Fund was not content with brokers' advice but relied rather upon an adviser which was not engaged in the brokerage business and which did not depend for its livelihood upon brokerage commissions. Advice from such an independent adviser is a commodity separate and distinct from the advice of a broker. The difference between a fund whose adviser is a broker and a fund whose adviser is not may well be of significance to an investor choosing between mutual funds. As the Court of Appeals noted in *Moses* v. *Burgin* in support of its holding that the adviser in that case was not required to establish a broker affiliate:

> "Plaintiff knew of Fund's practice [of not having a broker-affiliate] when she bought her shares; she could have chosen a fund which did have an affiliated broker."*

The possibility that brokers' advice could be obtained without charge without violating the antirebate rules has no bearing on the applicability of those rules to a broker's paying the Fund's bill from the independent non-broker Adviser selected by the Fund. Such payments to Adviser would have been just as much unlawful rebates as the payment of the Fund's other expenses, such as its electric bills or accountants' fees or the direct payment of a rebate check back to the customer.**

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* 445 F.2d 369, 375 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971). Similar points were made by Judge Wyzanski in his district court opinion in the same case, 316 F. Supp. 31 at 41-44.

**At page 13 of their reply to our main Amicus brief plaintiffs refer in a footnote to the testimony of Wetherill and Phelan in another case, *Papilsky* v. *Berndt*, 71 Civ. 2534, which was recently tried before Judge Frankel who reserved decision and in which the Amicus here is a defendant. Although we would normally object to a reference to testimony outside the record below we welcome it here and invite the Court to read the full testimony of both witnesses in *Papilsky* and the balance of the record in that case. Both go into the legality question in considerably greater depth than the record in this case or in any other case of which we are aware.

The care with which the stock exchanges have guarded against rebative arrangements whereby brokers in effect charge less than a full commission by paying customers' bills is illustrated by Rules 343 and 369 of the Rules of the New York Stock Exchange which are reproduced in the Appendix hereto. Indeed the only express rule on any exchange of which we are aware which would permit a broker to purchase independent advice and give it to his customer without additional charge appears at paragraph 2440A of the CCH New York Stock Exchange Constitution and Rules which is also reproduced in the Appendix. This provision would permit an exchange member to supply an advisory service to a customer only where the service is prepared by the member, or, if prepared by others, issued under the member's own name. In *Moses* v. *Burgin, supra,* in a finding which was not disturbed on appeal Judge Wyzanski noted that the rule only applied to published services and that such publications could only account for a "miniscule portion of the advisory fee" of a mutual fund. 316 F.Supp. at 44.

The difference between brokers' advice and independent advice explains why plaintiffs' NASD recapture schemes would have been unfairly discriminatory. If brokers were permitted to pay for the independent advice relied upon by mutual funds, but not for independent advice relied upon by other institutions or individual investors, mutual funds would be unduly favored over these other customers.

Plaintiffs' reference to the ancillary advisory services provided by bona fide brokers is really an argument that all investment advisers should have entered into the brokerage business and become brokers for all mutual funds or pension or other funds they managed. The law is clear that no mutual fund adviser was required to do this. See the authorities cited in our main Amicus brief, pp. 35-42.

The *Provident Management* case does not help plaintiffs because there the Commission expressly refrained from deciding upon the lawfulness of any of plaintiffs'

recapture schemes and pointed out in a footnote that its decision was not inconsistent with Judge Wyzanski's decision in *Moses* v. *Burgin* that NASD recapture of give-ups was unlawful.* In *Provident Management* the Commission dealt only with the question whether an affiliate of a mutual fund adviser which did no work and acted merely as a dummy broker could pocket commissions generated indirectly from the fund's portfolio transactions. The Commission's holding that this was unlawful and its approval of a practical settlement whereby the affiliate's ill-gotten gain was paid over to its fund sheds no light on whether the Chestnutt Corporation was required, or lawfully permitted, to recapture commissions for the benefit of its fund. The striking thing about the *Provident Management* case is that the SEC did not require any future recapture and apparently left the adviser free to use future portfolio commissions for encouraging sales of funds shares.

We submit that the foregoing and Part I of our main brief establish that plaintiffs have failed to meet their burden of proving that their recapture schemes were lawful. However, even if this Court should now hold — seven years after the abolition of give-ups and the introduction of quantity discounts, and four and one-half years after negotiated rates went into effect on trades involving $500,000 or more — that any form of recapture would have been lawful, that would still not dispose of the legality question.

Defendants were fiduciaries and as such had no duty to use other people's money to experiment with schemes of doubtful legality which might have resulted in any of the legal consequences referred to at pp. 24-33 of our main Amicus brief. Consequently, plaintiffs must establish not only that their recapture schemes were lawful, but also that this legality was clear enough at the time so that no legal experimentation would have been involved. Plaintiffs have

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* Provident Management Corp., [1970-71] CCH Fed. Sec. L. Rep. ¶ 77,937, at 80,087 n.14 (S.E.C. 1970).

failed to meet this burden. The nature of the legal climate relating to recapture has been well-stated as follows:

> "The problem with a case like *Moses* v. *Burgin* is that when that lawsuit, and others like it, was commenced, except for suggestions in a report such as the one issued by the SEC which does not have the force of law, mutual fund managers had no way of gauging their responsibilities in this complex, largely unchartered field. Before *Moses* v. *Burgin,* a fund manager had no way of knowing for sure that he was required to recapture brokerage in the manner suggested by the Court of Appeals. Beyond that, he had a reasonable fear that if he would attempt recapture in that way he would be violating antirebate rules of particular exchanges."*

The fact that Judge Wyzanski, who was the first judge to rule on the legality of recapture, held that most of the schemes suggested in this case by plaintiffs were unlawful demonstrates at the very least their doubtful legality. The decision of the Court of Appeals reversing him as to NASD recapture of give-ups (but not as to tender offer fee recapture or introducing broker or other broker affiliate recapture) did not remove that doubt outside of the First Circuit. Several district judges in the Second Circuit have added to the doubt by suggesting that the Court of Appeals decision in *Moses* has precedential value only where there is a failure to disclose information to a fund's unaffiliated directors (see p. 42 of our main Amicus brief). Consequently, plaintiffs have failed to establish that their recapture schemes were anything other than doubtful legal experiments in which careful fiduciaries should not engage.

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* Brodsky, *Liabilities of Mutual Fund Managers,* New York Law Journal, June 7, 1972, at 3, col. 1. *See also* E. Brodsky, Guide to Securities Litigation 211-15 (1974).

II.

The Decision Below Should be Affirmed in any Event Because of Defendants' Reliance Upon Advice of Counsel

In considering defendants' reliance upon legal advice it is important to focus upon the only two practical choices open to them. One was recapture of cash which would benefit the Fund only to the extent of the cash and then only to the extent that it caused no legal difficulties. The other choice, the use of give-ups and other excess commissions to encourage sales of fund shares, would also benefit the Fund (see pp. 35-39 of our main Amicus brief) and as it happened would benefit the Adviser. On this record there is no way of knowing which choice would have been of more ultimate benefit to the Fund. Indeed, so far as this record shows, even if recapture had been engaged in and been held lawful, it might well have been of less ultimate benefit to the Fund.

Under these circumstances, there is no point to plaintiffs' reliance upon two criminal fraud conspiracy cases* involving defendants who were found to have had the moral turpitude required in such cases and who did not escape conviction because lawyer members of the conspiracies allegedly advised them that they were acting lawfully. In the present case, no moral turpitude has been shown and defendants were advised in effect that plaintiffs' recapture schemes were unlawful because the Adviser could not properly join NASD or an exchange without going into the brokerage business.** Consequently, they chose what appeared to be the only lawful way of using give-ups and other excess commissions which would benefit the Fund. The cases cited at pp. 33-34 of our main Amicus brief make it clear that under these circumstances the alleged self-inter-

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* Shusan v. United States, 117 F.2d 110, 118 (5th Cir.), *cert. denied,* 313 U.S. 574 (1941); United States v. Piepgrass, 425 F.2d 194, 198 (9th Cir. 1970).

** Trial Transcript 229-30; Ex 23, pp. 21-24, 37-38, 41-49, 52-54, 66-68.

est of Fund's attorneys did not make it improper for the Fund to rely upon their advice.

In questioning the reasonableness of defendants' reliance upon legal advice plaintiffs apparently question the depth to which the attorneys explored the law and the reasonableness of the advice. However, the conclusions were reasonable enough for Judge Wyatt to concur in them. The circumstances surrounding the rendering of the advice show that it was reasonably relied upon. The practice of the law would be much too expensive if a lawyer had to prepare a formal written opinion every time he gave advice to a regular client. Here where there is apparently no dispute about whether the advice was given, the fact that it was given orally is of no significance.

General rules as to when a trustee must disgorge his profits also have no bearing here for at least two reasons. First, the defendants are not trustees but rather are corporate officers and directors and an investment adviser and hence are held only to the standards applicable to such persons. As Judge Herlands pointed out in *Brown* v. *Bullock*, 194 F.Supp. 207, 241-245 (S.D.N.Y.), *aff'd*, 294 F. 2d 415 (2d Cir. 1961), the Investment Company Act of 1940 was adopted with the specific thought that such persons would not be held to a strict trustee standard. Plaintiffs are unable to cite any cases in which investment company officers and directors have been held liable for anything other than the types of serious misconduct for which corporate officers and directors are normally held liable. Under such standards, which were applied in the cases cited in Part II of our main brief, there is no liability where officers and directors happen to benefit because they reasonably rely on legal advice.

Second, even if the trustee standard applies, it would not call for liability in this case. Plaintiffs are unable to cite any case in which a trustee has been surcharged under similar circumstances. There would be no equity in holding

that the Fund which has already benefited once from the commisions involved in this case should receive the benefit of them a second time.

III.

Defendants Had No Obligation to Recapture Even If Recapture Involved No Legal Problems

Plaintiffs' attempt to show that the Fund's charter requires recapture is based upon a provision requiring that the Fund receive the "net asset value" of each share sold. In considering this provision, the first inquiry should be into how "net asset value" per share is calculated. This is done by dividing the Fund's total "net asset value" by the number of shares outstanding. Only when this calculation has been made is it possible to determine whether "net asset value" has been received.

Plaintiffs' arguments relating to the charter are based upon the suggestion that this calculation is irrelevant. This is fallacious since it will not do to rely on a charter provision and then ignore what it says. When the net asset value referred to in the charter is taken into account, it is clear, as we show in our main Amicus brief, at pp. 39-41, that there is nothing in the Fund's charter which requires it to recapture commissions, especially in view of the doubtful legality, if not complete illegality, of plaintiff's recapture schemes. It was therefore quite proper for defendants to elect not to recapture, as Judge Carter held in *Tannenbaum* v. *Zeller,* CCH Fed. Sec. L. Rep. ¶ 95,257 (S.D.N.Y. July 30, 1975).

Conclusion

For the foregoing reasons and for those stated in our main Amicus brief, the decision below should be affirmed.

October 29, 1975

Respectfully submitted,

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APPENDIX

The following rules and provisions are taken from the July 1, 1967 CCH New York Stock Exchange Rules and Constitution and they remained in effect without any substantial amendments until May 1, 1975:

¶ 2343 Offices—Sole Tenancy, Hours, Display of Membership Certificates, Expenses

Rule 343. (a) Each office of a member or member organization, or foreign incorporated branch, shall be used solely for said business and, except as permitted by the Exchange, shall not be occupied jointly with any other member or non-member.

(*See* ¶ 2321.10, 2321.34 *for corporate affiliate requirements.*)

(b) Unless otherwise permitted by the Exchange, the main office of every member or member organization shall remain open for business on every full business day during the trading hours on the New York Stock Exchange.

(c) Members and member organizations maintaining customers' offices are required to display in each such office a certificate of membership provided by the Exchange. Such certificate shall be at all times the property of the Exchange, and every such certificate shall be returned upon demand of the Exchange or upon termination of the office or of the member's status as a partner, voting stockholder or member.

(d) The person in charge of any office of a member or member organization shall not be paid a gross sum for the expenses thereof, such as rental, clerk hire or other expenses, but all expenses of such office shall be borne directly by the member or member organization.

Amendment.
April 16, 1964.

• • • ***Supplementary Material:***

Information Regarding Office Space Arrangements

.10 The Exchange, under Rule 343, above, permits the following office space arrangements:

.11 **Member—Non-member.**—A member or member organization may:

(1) Furnish office space free of charge or on a rental basis to their own corporate affiliates; or

(2) furnish office space free of charge to a non-member customer provided the non-member does not conduct a business with the public from such space. A non-member who operates

discretionary accounts on a fee or other compensation basis is deemed to be conducting a business; or

(3) sublease space to non-members at rentals reasonably comparable to the going rate for like space, provided

(A) such space is separated by ceiling-high solid walls from the space occupied by the member organization; and

(B) such space has direct access to a public hall, main corridor or street; and

(C) the name of the non-member is placed on the door to such space; and

(D) there are no connecting doors or windows between the space to be occupied by the non-member and that occupied by the member; and

(E) the name of the non-member is not listed under the same telephone number as that of the member, and the telephone number of the member is not used on letterheads or or in any advertising of the non-member.

No facilities within the offices of such non-member may be paid for by the member, except as provided in Rule 369(E) [¶ 2369].

The fulfillment of the foregoing conditions is not required if the non-member is a fellow member of another exchange and the arrangement is not contrary to the rules of such other exchange, and the non-member limits his business to Floor brokerage on the other exchange and/or the introduction to the member of this Exchange, on a disclosed basis, of accounts trading in securities or commodities dealt in on the other exchange, and the non-member does not regularly solicit or service such customer business.

Applications for permission to enter into any of the above arrangements should be submitted to the Department of Member Firms.

(See ¶2334 *for joint office requirements.)*

.12 **Keeping the books of non-member.**—Without the prior approval of the Exchange, no member organization may do any of the bookkeeping for a non-member.

.13 **Member-Member.**—Clearing member organizations may furnish office space, telephone, ticker and other facilities, or any of them, to non-clearing member organizations, provided

(1) All of the business of the non-clearing organization, where possible, is introduced to, or cleared through, the clearing organization which is furnishing the subsidy.

(2) The clearing organization shall at any time be prepared to demonstrate to the Exchange

(A) that the split of commissions on introduced listed business is at least greater than the minimum clearance rate, by the amount of the subsidy, and

(B) in respect of other types of business done by the introducing organization, whether on a principal or a brokerage basis, the clearing organization shall receive a clearing fee of not less than the prescribed minimum rates of the Exchange where the securities or commodities are dealt in; clearing charges on unlisted securities to be by mutual agreement.

¶ 2369 Prohibited Arrangements, etc.

Rule 369. While not in any way limiting the meaning or effect of Section 1, Article XV [¶ 1701] of the Constitution, prohibiting rebates of commission, a member, allied member or member organization may not make any of the following arrangements, agreements or payments:

Unusual interest rates or money advances

(1) An arrangement with a customer whereby special and unusual rates of interest are given or money advanced upon unusual terms for the purpose of obtaining or retaining business.

Interest on short sales

(2) An allowance of interest on short sales at more than the loan market rates for the stocks borrowed or used for such short sales.

Stamp taxes, etc.

(3) The assumption, by agreement or otherwise, of any part of

(A) any stamp tax imposed by the United States or any State on transfers, sales, loans, or borrowings for the account of a customer;

(B) any charge upon the sale of securities upon the Exchange because of the registration fee imposed upon national securities exchanges by the Securities Act of 1934.

(C) any commission payable upon transactions in commodities or securities dealt in upon another exchange;

Bank charges for handling securities

(D) any charge made by a bank or trust company for such services as handling a draft with securities attached which is deposited with them for collection; safekeeping of securities for the account of a customer; receiving securities

with or without draft attached, against payment or against receipt; delivering securities against receipt or payment; effecting transfer, registration, subscription, or exchange of securities, *provided* that if the amount of such charge on all transactions for one customer on a single day is less than $1.00, the charge may be waived by the member or member organization;

Office expenses of non-members

(E) any expense pertaining to the office of a non-member except the cost of maintaining a private means of communication with the non-member provided that such cost is not in contravention to the provisions of ¶ 2359.10 Private Wires and Other Connections;

Statistical and investment advisory services

(F) any expense for services rendered to a non-member which is in contravention to the provisions of Statistical and Investment Advisory Services (¶ 2440A);

(G) any charge for shipping securities to or from a non-member or correspondent which is in contravention to the provisions of paragraph (c), Shipping and Postage Charges (¶ 2381.11).

Contracts of a customer

(4) The assumption of a contract made for a customer after a loss has been established and ascertained unless (A) the contract was made in error or (B) the consent of the Exchange has been obtained.

(*See Rule* [¶ 2411] *re Erroneous Reports.*)

Office space arrangements

(5) An arrangement involving the furnishing of office space to members, member organizations and non-members which is in contravention to the provisions of Rule 343 [¶ 2343] and allied material, Office Space Arrangements.

Gratuities to employees

(6) The payment of any gratuity to any employee of the (A) Exchange or subsidiary thereof, (B) a member or member organization, (C) a non-member which is in contravention to the provisions of Rule 350 [¶ 2350] and allied material, Employees.

Cost of transmitting orders

(7) The payment of the cost of transmitting orders for the account of another member or member organization or non-

member or his or its customers which is in contravention to the provisions of ¶ 2359.10 and 2359.14, Private Wire and Other Connections.

¶ 2440A Statistical and Investment Advisory Services

• • • ***Supplementary Material:***

[*Also see Rule* 369(3)(F) (¶ 2369).]

.10 To whom furnished.—A member or member organization may furnish:

(1) To a professional non-member (i.e., broker-dealer in securities or commodities, insurance company, investment advisor, investment manager, bank, trust company, foundation, professional trustee, or one engaged in any closely allied activity), statistical and investment advisory services:

(A) Prepared by the member or member organization; or

(B) prepared by others and reissued by the member or member organization in his or its own name with the consent of the original issuer or publisher, provided the reissuing member or member organization is not required to pay for such consent.

(*Exception*: *This policy does not prohibit the furnishing by a member or member organization to a non-member professional (i.e., broker-dealer in securities or commodities, insurance company, investment adviser, investment manager, bank, trust company, foundation, professional trustee, or one engaged in any closely allied activity), of publications of nominal cost, i.e., aggregating not more than approximately* $30 *per year, per non-member professional.*)

(2) To another member or member organization or to a non-member customer who is a non-professional, statistical or investment advisory services

(A) prepared by the member or member organization, or

(B) prepared by others and reissued by the member or member organization.

The meaning of "statistical and investment advisory services" above is restricted to publications or services intended to aid professional or non-professional clients of member organizations in investment decisions concerning securities or commodities. All such publications or services must be clearly and prominently identified as being a publication or service of the original issuing member organization. (The name of the original issuing member organization

may be omitted if the distributing member organization clears its listed business through the issuing member organization.)

.11 **Fees.**—Such service which is prepared or reissued by the member organization consistent with .10 above, may be furnished by the member or member organization to another member or member organization or to a non-member, either free of cost or on a fee basis. If such service is furnished on a fee basis, the fee may be adjusted in accordance with commission business received from the other member or member organization or from the non-member.

The fee for investment advisory service may be based on a percentage of the principal amount of the funds involved but may not be based upon the profits realized.

Different fees may be charged to different customers for the same or equivalent statistical service.

.12 **Commissions to employees.**—A commission of a fixed proportion of the fee received by the member or member organization from the non-member may be paid to employees of the member or member organization.

.13 **Office space.**—Occupancy of a member's or member organization's quarters by a non-member engaged in the business of rendering any type of statistical or investment advisory service is in contravention of the office space rules of the Exchange.

.14 **Disclosure of interest.**—If a member or member organization, or any organization in which the member or any of his or its partners or holders of voting stock have an interest furnishes statistical or investment advisory service, and the member or member organization or any of his or its partners or holders of voting stock is substantially interested in any security recommended, a full description of such facts shall be made to customers who subscribe to the service.

.15 **Exceptions.**—The rules outlined in items (1), (2), (3), (4) and (5) above do not apply to the occasional information supplied by a member or member organization to another member or member organization or to a non-member customer, upon request, such as individual corporation analyses, specific excerpts from recognized standard statistical services, etc.

.16 **Other Services.**—Except as provided in ¶ 2343.11 and 2343.12, member firms may offer to non-member professionals other types of services, provided that the cash compensation for such services is sufficient to cover all direct and indirect costs of the service. Such services may be so offered contingent on the non-member also giving the member firm commission business, provided that all promo-

tional literature, order forms and bills contain a direct statement that the cash charge covers all costs of creating, producing and distributing the service.

.17 Services prepared by other members or member organizations.—A member or member organization may subscribe, for his or its own use, to a service prepared by another member, member organization or non-member. The fee paid for such service shall be commensurate with the service rendered and with the fee charged by other organizations for the same or similar services, and commensurate with the fee charged by the issuing organization to other subscribers for the same or similar services.